

Globalization and its discontents: Navigating the dangers of a tangled world

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[Previous](#) Article 29 of 84 [Next](#)

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[Citation](#) [Abstract](#)
[Full Text](#) [Page Image](#)

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Abstract:

Haas and Litan argue that the crises of globalization will be solved neither by a super-IMF nor an unfettered market. The solution is to develop ways to warn banks and other creditors that they will suffer in the event of a future crisis.

Full Text:

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The period immediately following the Second World War, which produced the Marshall Plan, NATO, and the U.S.-Japan security treaty, is rightly regarded as foreign policy's golden era. But it also saw the birth of comparably successful economic institutions-such as the International Monetary Fund, the World Bank, the General Agreement on Tariffs and Trade-designed to promote long-term prosperity through stable exchange rates, worldwide development, and open trade. Today these institutions are increasingly subject to criticism. The IMF, for instance, has come under attack for imposing drastic conditions in its "rescues" of Mexico in 1995 and Asia today. The World Trade Organization, formed in 1995 as the result of American calls for a body to resolve market-access disputes, has been attacked in this country for usurping America's sovereignty. And doubts abound about the role of development banks in an era of massive direct foreign investment.

The gap between the legacy of Bretton Woods and the economic and political demands of the modern world is growing. Much of this change is driven by rapid advances in, and thus lower costs of, communications, information flows, and travel. Official policy, much

of it American, has played its part by reducing barriers to the movement of goods and capital across national boundaries. The result has been more intrusive and intense economic interaction-including the explosive growth of world capital markets, which led to the demise of fixed exchange rates-between a large and growing number of entities outside government control, a phenomenon that has come to be called "globalization."

But globalization has its problems. In some quarters it is seen as having caused the rapid flows of investment that moved in and out of countries as investor sentiment changed and were behind the Mexican and Asian financial crises. In the United States it is blamed for job losses, increasing income inequality, and stagnant or deteriorating real wages. Domestic discontent with globalization thwarted the passage last year of legislation that would have granted the president "fast track" authority to negotiate trade arrangements that Congress could not modify

Globalization has become a target. Its dangers must be navigated successfully or the United States and others may be compelled to backtrack, diminishing the free movement of goods, services, and capital, which would result in slower growth, less technological innovation, and lower living standards. FREE-MARKET FOREIGN POLICY?

In this new world, poor economic policymaking, corrupt banking practices, dishonest accounting, and unrealistic currency alignments can have an impact on societies far removed. Although the United States, with its vast internal market, is considerably less "globalized" than other industrialized countries, millions of American jobs and billions of dollars are tied to economic developments elsewhere.

If there is consensus on the diagnosis, there is none on the prescription. There are at least three fundamentally different approaches to addressing the problems of the global economy.

The first embraces the free market and would abandon IMF-like rescue packages. It is motivated by the belief that the IMF lulls governments, investors, and lenders into recklessness. Emboldened by the prospect that the IMF will come to their rescue, they are free to act irresponsibly. In the words of George Shultz, William Simon, and Walter Wriston, IMF "interference will only encourage more crises." Mexico, in this view, led to Asia.

The laissez-faire, free-market approach looks good in the abstract because markets reward sound investments and regulatory practices and punish poor ones. In principle, it can provide incentives for investors to avoid overly risky investments and for governments to adopt prudent policies. To international free marketeers, safety nets destroy this incentive.

But this critique goes too far. Governments submitting to IMF rescue plans must often agree to wrenching reforms-not the kind of experience that invites other governments to be reckless. Similarly, investors in equity markets in Mexico and Asia were hit by depressed local stock prices and heavily devalued local currencies. The only parties that emerged relatively unscathed, and thus for whom the free market critique has some

relevance, were certain creditors: holders of Mexican government debt during the Mexican crisis and banks in the recent Asian crisis.

The solution to this problem is not to remove the IMF—the international lender of last resort—but to develop ways to warn banks and other creditors that they will suffer in the event of a future crisis. During the Depression, Americans learned the cost of not having a functioning lender of last resort: a wave of bank and corporate failures, aggravated by a shortage of liquidity that the Federal Reserve failed to provide. The international equivalent of having no Fed is standing idly by while currencies plummet, countries run out of foreign exchange, trade and investment come to a halt, and crises in one region spread to others.

A hands-off approach would risk transforming limited crises into something much more costly. More than economics is at stake. Years of punishment by the marketplace are simply not acceptable when immediate strategic interests are involved, as they are, for example, in Mexico or South Korea. For better or worse, the United States cannot afford the collapse of countries vital to its national interest.

GOVERNING GLOBALIZATION

The second approach to taming the dangers of globalization could hardly be more different. It suggests the creation of new institutions to lend structure and direction to the global marketplace, complementing what is seen as the constructive but inadequate roles of the IMF and other bodies. For example, George Soros, arguing that "international capital movements need to be supervised and the allocation of credit regulated," has recommended creating the international equivalent of the United States' Fannie Mae, which guarantees residential mortgages for a fee. He calls for the establishment of an "International Credit Insurance Corporation" that would guarantee private sector loans up to a specified amount for a modest charge, while requiring that the borrowers' home countries provide a complete financial picture in order for them to qualify. Henry Kaufman, a Wall Street economist, would go even further, creating a "Board of Overseers of Major International Institutions and Markets" that would set minimum capital requirements for all institutions, establish uniform accounting and lending standards, and monitor performance. It would even discipline those who did not meet these criteria by limiting the ability of those who remained outside the system to lend, borrow, and sell. Governments are sure to resist supranational bodies that so fundamentally challenge their sovereignty. Moreover, except for extreme crises when an IMF-like rescue is warranted, it is difficult to understand why international officials could determine how much credit to allocate better than the market. There is more than a little irony in applying the "Asian model" of centralization to the international economy just when the model has been so thoroughly discredited.

A third approach, which would leave the basic architecture of the international economy alone but still do some "remodeling," would involve a number of reforms designed to structure and discipline financial operations and transactions. This managed approach would eschew the heavy hand of international regulation but aim to maintain the element of risk essential to capitalism without removing the safety net provided by the

IMF. This approach is closest to the manner in which the United States dealt with the savings and loan and banking crises of the 1980s: enacting legislation requiring shareholders to maintain a larger financial commitment to their banks while making it more difficult for regulators and policymakers to bail out large, uninsured depositors who could previously count on being protected. The challenge for the international community is to introduce the equivalent of the U.S. reforms at both the national and international levels.

Such reforms are already being worked on at the behest of the IMF. They include improving the supervision of financial institutions, instituting Western-style accounting practices in banks and corporations, and opening up markets to foreign investment. To ensure that these reforms are carried out, some other international body, such as the Bank for International Settlements or perhaps a nongovernmental organization, should issue regular "report cards" on individual countries' progress. In addition, the IMF must press countries to be forthcoming with accurate information about key financial data, including their current account positions, foreign exchange reserves, and short-term indebtedness to foreign creditors. Banks and investors will favor countries that are positively rated, and penalize or avoid those that are not. Governments and institutions will introduce desirable reforms lest they lose out.

More transparency and information is necessary but not sufficient for markets to avoid excesses. The challenge is to find effective ways of addressing the free market critique. A possible solution is for the IMF to condition its assistance on countries' penalizing all lenders of foreign currency in the event IMF intervention is required. In particular, the model legislation that each country could adopt would require (as long as an IMF rescue is in effect) that creditors automatically suffer some loss of their principal when their debt matures and is not rolled over or extended. This approach would discourage the sudden outflow of maturing debt when countries can least afford it. The threat of automatic loss in the event a country experiences economic crisis could underscore to banks and other creditors that their money is at risk and that they can no longer count on the IMF to bail them out. Creditors would respond, of course, by insisting on higher interest rates for borrowers with opaque or poorly capitalized balance sheets. But that is precisely the point: the price of loans should better reflect the risk of not getting repaid.

The Asian crisis demonstrates the need for more formal bankruptcy codes and mechanisms for restructuring the balance sheets of heavily indebted firms without necessarily shutting them down. Existing international institutions can assist countries in this area, as well as in strengthening bank supervision and accounting standards, but there is no need to establish a new international bankruptcy court or to vest existing international institutions with such powers. The United States has a bankruptcy code and process that handles insolvency of firms located here, even when they have foreign creditors. There is no reason why other countries cannot do the same thing. THE HOME FRONT

To paraphrase former House Speaker Tip O'Neill, all economics is local. Policies promoting unfettered trade and investment will be rejected by Congress unless steps are taken to build a firm domestic political base. Once again, there are three approaches to choose

from, running the gamut from laissez faire to heavy regulation. A pure market approach—one that would let the chips (and the workers) fall where they may—would be neither fair nor politically sustainable. Some sort of safety net is both desirable and necessary. At the same time, it would be foolish to try to insulate Americans from all of globalization's effects. It is impossible to protect jobs rendered obsolete by technological change and foreign competition. What lies between is a managed approach that helps workers cope with the consequences of globalization. It would both change and supplement existing programs and policies. Since 1962, American policymakers have provided extended unemployment insurance to workers who can prove they were displaced primarily because of international trade. But this discourages workers from looking for employment, channeling them toward government training programs with little proven success. Moreover, it does not compensate workers for the cuts in pay they take even after finding new jobs. A more effective program would pay workers a portion of the difference between their wages at their previous and new jobs. This kind of earnings insurance would encourage workers to take new jobs even if they paid less, and offer the only real training that works—on the job. Workers could also be provided with benefits—health insurance, pensions, training, and unemployment insurance, that they could take with them when moving to a new employer.

Some will argue that portable benefits and earnings insurance are not enough. But globalization is a reality, not a choice. "You can run but you can't hide" might serve as the mantra for the age.

Those who urge us to hide by resurrecting barriers to trade and investment, with the ostensible aim of insulating Americans from the forces of globalization, would abandon America's commitment to the spread of markets and democracy around the world at precisely the moment these ideas are ascendant. Moreover, the potential economic and political cost would be enormous, depriving Americans of cheaper and in some cases higher quality goods and services, as well as denying them the opportunity to work at better paying jobs that depend on exports.

The real choice for governments is not how best to fight globalization but how to manage it, which will require creative policies both at home and abroad. It is ironic: the age of globalization may well be defined in part by challenges to the nation-state, but it is still states and governments—by the practices they adopt, the arrangements they enter into, and the safety nets they provide that will determine whether we exploit or squander the potential of this era.

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